BETTER MARKETS

– FACT SHEET –

The SEC Must Finalize a Comprehensive Framework For the Use of Derivatives by Mutual Funds

On March 24, 2020, Better Markets filed a comment letter in response to the Securities and Exchange Commission's re-proposal of a new regulation establishing a number of sensible risk management, governance, and leverage requirements designed to mitigate risks associated with the use of derivatives by most registered open-end or closed-end funds and business development companies under the Investment Company Act of 1940 ("ICA").

Although we express significant reservations about certain elements of the re-proposal and in particular, the abandonment of the asset segregation framework and the introduction of new proposed derivatives-related leverage limitations (the relative and absolute value-at-risk (VaR) approach), we support initial steps to implement a comprehensive regulatory framework for funds using derivatives-related leverage and posing derivatives-related risks to the U.S. financial system and investors.

Why are quantitative leverage limitations on funds important?

The use of leverage by funds, including so-called "synthetic" leverage obtained through derivatives, can present significant risks to U.S. financial stability and investors. Although derivatives-related leverage can amplify positive returns for investors and be risk reducing, it also can exacerbate risks arising from asset price or risk attribute movements not only to the fund itself and its investors but also to other market participants. These risks are likely to be most pronounced in adverse market conditions requiring funds to de-leverage, resulting in correlated "fire" sales of securities with other leveraged firms and often requiring sales of already de-valued assets to meet redemption requests and other liquidity needs, including margin calls. Furthermore, these stresses may occur as funds experience other market and liquidity stresses, which, in turn, can be expected to affect availability and costs of short-term funding for fund investment activities.

What is the primary benefit of the SEC's re-proposal?

A significant value of the re-proposal is that it would institute a single, uniform, enforceable derivatives framework in place of the current bibliography of more than 30 releases, including a 40-year-old SEC policy statement, dozens of SEC staff no-action letters, and informal guidance based on specific representations and fact-specific, instrument-by-instrument analyses.

What are the most significant concerns and drawbacks of the SEC's re-proposal?

Better Markets raises significant concerns with the SEC's re-proposal, in particular with respect to the proposed new VaR framework that would replace the longstanding asset segregation framework designed to limit the use of derivatives by funds.

Proposed Abandonment of the Asset Segregation Framework:

The SEC and its staff have provided longstanding derivatives-related ICA section 18 policy statements and no-action relief requiring the segregation of high-quality, stable assets in connection with fund derivatives activities.

The re-proposal would abandon that approach after at least four decades.

Overreliance on VaR-Based Leverage Measures:

The Relative VaR and Absolute VaR tests in the re-proposal have merit, but they do not measure leverage directly and do not fully address ICA section 18 concerns.

- For example, the SEC's Relative VaR proposal could mask risks through the volatility of designated benchmarks, facilitate excessive leverage through model errors and limitations in extreme but plausible market conditions, and raise data reliability concerns with respect to VaR calculations for elements of fund portfolios.

- Furthermore, the selection process for designated reference indices (essentially the benchmarks against which a fund's portfolio would be measured for Relative VaR purposes) is too ambiguous, is susceptible to tracking error and manipulation, and could result in systematic underestimation of derivatives-related leverage.

The Relative VaR test therefore must not be adopted to the exclusion of supplemental measures, like the asset segregation framework, that indicate and mitigate excessive derivatives-related leverage.

Conclusion

The SEC's re-proposal neither reflects perfectly our ideal derivatives framework for funds nor eliminates derivatives-related leverage risks. However, it does more than current law and guidance to bring discipline, uniformity, and enforceability to market practices, and many proposed elements represent a reasonable initial effort to codify quantitative boundaries for derivatives-related leverage. Therefore, we support critical elements of the SEC's proposal to establish governance and risk management (including stress testing) frameworks reasonably designed to address the full range of derivatives-related risks posed to funds and related risks and risk exposures (although we encourage the SEC to reinstate the asset segregation framework in its final regulations, make a number of suggested amendments to the VaR framework, and be more attentive to model risk management, valuation and accounting, credit, and liquidity risks and risk exposures).

Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside and protect investors and consumers.